Financial Markets

Irving Trust

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Much talk about producer prices, much action on rapidly shifting perceptions of Federal Reserve policy, heavy new supply and hesitant demand--all in all, it was a confusing week; and by Friday morning, dealers were wondering which way to jump next. It may be too soon to say that the five weeks' mega-rally has finally hit the inevitable snag. Fed moves, however, are suddenly flashing warning signals, and at least a pause in the recent rate free-fall seems to be taking shape.

Early in the week, the rally forged ahead as rates dropped sharply in the face of significant new supply (the Treasury refunding, a big corporate calendar, a jump in C.D. writing activity). In the government sector rates fell across the board--90-day bills, 10.65% last Friday, traded as low as 9.10%--and other markets kept the pace. Some of the euphoria may have been due to anticipation of a sharp drop in the producer price inflation rate; this was confirmed with Friday's report of a 0.5% April rise (vs. 1.4% in March, and in the middle of the expected range).

The real engine of this week's early advance, however, seems to have been a perceived easing in Fed policy. Last Friday, the central bank provided liquidity to the system when Fed funds were trading at 14.625%, and the Fed seemed willing to tolerate a funds rate of 11%. This implied that the former 13%-20% band had been moved lower in a policy easing, a possibility that seemed even more likely with Wednesday's removal of the three percentage point surcharge on the discount rate. Markets immediately began searching for a new lower limit, and rates on some instruments were marked down to levels that would match a funds rate of less than 10%.

That, it seems, was at last too much too soon--the funds rate does not appear to be moving back into single digits just yet. On Thursday, the Fed moved to drain liquidity when funds were trading at 10.375%. This unexpected action caught the markets in a somewhat uncomfortable position; supply pressures are heavy; dealer inventories are high; and retail demand is a bit skittish, with many investors looking for reasons to take profits. Once the expectation of more near-term drops in the funds rate was challenged, it began to look as if markets had run ahead of themselves, and prices gave up a good portion of the week's gains, particularly in intermediate and longer maturities.

This was hardly a major correction--the markets ended up with substantial net gain for the week--but some correction seems inevitable (if rates kept falling at the April pace, Fed funds would hit zero sometime in mid-June). Current price levels incorporate very bullish expectations on the severity of the recession, the drop in inflation, and the trend of Fed policy; thus any interruption in a steady diet of good news is likely to produce a certain degree of indigestion.

The key variable at this point (aside from the funds rate, of course) is the money supply. The surprising speed with which the Fed let rates drop after April 1 was probably due in part to sharp drops in the seasonally adjusted money supply numbers. As has been widely mentioned, the nonseasonally adjusted numbers have been rising rapidly, and the adjustment program has been disputed in the past. This means that money supply data could show sharp volatility--up as well as down--in the coming months; thus the funds rate may continue to be volatile as well.

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Market Yields

	5/9/80	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	(noon)		
Short-term loans to substantial depositors with highest credit rating	17.50	18.50%	11.75%
Effective since	5/7/80		
Discount Rate at Federal Reserve Bank	13.00	13.00/16.00	9.50
Federal Funds	10.63	14.50	10.23
Repurchase Agreements	8.25	11.75	9.85
U.S. Treasury Issues			
Bills			
3 months	9.22	10.65	9.95
6 months	9.56	10.92	10.20
1 year	9.89	10.75	10.18
Coupons			
2 years	9.79	10.56	9.88
4 years	9.95	10.62	9.33
7 years	10.37	10.56	9.32
10 years	10.41	10.52	9.34
Long Bond	10.44	10.69	9.25
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.25	12.55	10.05
3 months	10.25	12.55	10.25
6 months	10.20	12.45	10.60
1 year	10.20	11.60	10.70
Banker's Acceptances			
1 month	9.95	12.32	9.98
3 months	10.00	12.42	10.20
6 months	10.10	12.50	10.60
Eurodollar Deposits			
1 month	10.88	14.00	10.44
2 months	11.38	14.13	10.69
3 months	11.50	14.13	10.88
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	7.00	11.00	9.75
1 month	9.00	11.25	9.90
3 months	9.25	10.75	9.75
Bank Holding Companies			
1 month	9.38	12.00	9.95
Dealer Placed:			
3 months	9.50	12.00	10.00
New AA Corporate Utility Bond	12.00	13.70	10.10
Tax Exempt			
6 month Project Notes	5.25	6.25	5.10
1 year AAA Bond	5.40	6.05	N/A
5 year AAA Bond	5.35	6.10	N/A
20 year AAA Bond	6.10	7.30	5.90

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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